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Development Economics

Office of the Vice President
Development Economics
The World Bank
January 1989
WPS 152

Subsidies and Countervailing Measures

Economic Considerations

Bela Balassa

The present rules on export subsidies and domestic subsidies should be revised to conform better to economic principles and to limit distortions in international trade.

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The present rules on export subsidies and domestic subsidies should be revised to conform better to economic principles and to limit distortions in international trade. To begin with, the illustrative list of export subsidies should be made definitive, with appropriate revisions. These revisions would eliminate the dual pricing of inputs and remove requirements of the physical incorporation of inputs for the exemption and remission of indirect taxes and import charges. Also, the exception made for primary products in regard to the prohibition of export subsidies should be eliminated.

Only measures which are specific to an enterprise or industry should be considered domestic subsidies. At the same time, it would be desirable to strengthen existing rules on domestic subsidies. This could be accomplished by prohibiting domestic subsidies that exceed a certain percentage of output value as well as domestic subsidies provided in cases where exports account for a large proportion of output.

Developing countries receive preferential treatment in the application of GATT rules on export subsidies. They are exhorted, however, to reduce or eliminate export subsidies which are inconsistent with their competitive or development needs. It is suggested that procedures be established to phase out export subsidies in the case of advanced developing countries as well as in cases when an industry of a developing country is internationally competitive.

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SUBSIDIES AND COUNTERVAILING MEASURES: ECONOMIC CONSIDERATIONS

Bela Balassa*

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Bela Balassa

This paper will examine issues relating to subsidies and countervailing measures and make recommendations for changes in existing rules on the basis of economic considerations. This will be done by analyzing, successively, the concepts of subsidies (Section I), countervailing measures and serious prejudice, nullification or impairment (Section II), and the special treatment of developing countries (Section III).

I. Concepts of Subsidies

Economic Effects of Export Subsidies

There is a basic assymetry in GATT. While import tariffs are accepted under GATT rules, export subsidies are prohibited, with exception made for the subsidization of primary exports and subsidies by the developing countries. Yet, import protection and export subsidies are symmetrical in their economic effects: they favor production in the country imposing such measures at the expense of production in other countries for foreign or for domestic markets; in so doing, they introduce distortions in international trade.

A solution to this puzzle may lie in the emphasis on incremental measures, on the assumption that the point of departure is a set of "bound" tariffs and no export subsidies. Now, GATT prosc.ribes increases in tariffs from their bound level as well as the imposition of export subsidies. Under this interpretation, the rules aim at avoiding additional distortions in international trade, whether in the form of increases in import tariffs or the imposition of export subsidies.

An alternative explanation is that countries react differently to measures applied in foreign markets and to measures that affect their domestic markets. They consider foreign trade barriers as reflecting the economic sovereignty of the countries concerned, while they regard foreign export subsidies as interfering with their own economic sovereignty.

An additional consideration is that export subsidies affect third country markets in distorting the conditions of competition among foreign exporters in these markets. In so doing, they interfere with international specialization according to comparative advantage. A case in point is the agricultural subsidies provided by high-cost producers that limit the export possibilities of low-cost producers.

In the following, we will review existing GATT rules on export subsidies on the basis of economic considerations. The scope of the discussion will further be extended to encompass domestic subsidies.

Export Subsidies on Products other than Primary Products

According to the General Agreement, "contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market" (XVI:4). This prohibition, applying to developed countries that signed the 1960 Declaration on Article XVI:4, was reaffirmed in the Tokyo Round Code on Subsidies and Countervailing Duties promulgated under the title "Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade."

But the Code eschews any reference to the dual pricing rule in simply stating that "signatories shall not grant export subsidies on products other than certain primary products" (9:1). This can be considered an improvement since subsidization does not necessarily lead to lower export than domestic prices. Such may be the case, for example, if subsidization takes the form of preferential export credits, guarantees, and insurance, or if exporters take higher profits.

At the same time, the Code refers to the practices listed in the Annex, which "are illustrative of export subsidies" (9:2). Thus, we do not have a definitive list of export subsidies but only an illustrative list. This fact creates uncertainty in the application of the GATT rules.

Uncertainty could be reduced if the Contracting Parties to the General Agreement adopted the illustrative list as definitive, following appropriate revisions. Contracting parties would, then, have the responsibility not to grant the export subsidies listed, with exception made for primary products and for developing countries.

The list includes ten specific items as well as a general category, which covers "any other charge on the public account constituting an export subsidy in the sense of Article XVI of the General Agreement." The last point leads to the question if budgetary cost (a charge on public account) should be considered a necessary condition for there being an export subsidy.

Such is not necessarily the case for item (b), under which "internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favorable than for domestic shipments" is considered an export subsidy. Also, in item (d) reference is made to actions by government agencies, whose budget may not be integrated with that of the

government. Finally, export credits may be provided by "special institutions controlled by and/or acting under the authority of governments" (item k) without there being a budgetary cost. For example, banks providing export credit may be subject to lower reserve requirements.

It would appear, then, that there being a budgetary cost is not necessarily a condition for an export subsidy. At the same time, several items on the subsidy list may be reconsidered.

Item (d) concerns "the delivery by governments or their agencies of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favorable than for delivery of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favorable than those commercially available on world markets to their exporters." This item permits dual pricing for inputs: charging lower prices for inputs used in production for the export market than for the same inputs used in production for the domestic market is permissible as long as these prices are not below world market prices. Such dual pricing should be considered a subsidy to exports, which are favored over domestic production.

Further questions arise in regard to item (h), which permits exemption, remission, or deferral of indirect taxes on goods and services used in export production if "the prior stage cumulative indirect taxes are levied on goods that are physically incorporated (making normal allowance for waste) in the exported products." The same condition appears in item (i) that relates to the remission or drawback of import charges.

These clauses exclude indirect taxes and import charges on services, such as transportation and communication, as well as on machinery, and on fuels and electricity used to operate machinery, which are not physically incorporated in the product Such a distinction does not have an economic rationale, and the rules on indirect taxes and import charges should be applicable to all inputs. In the case of machinery, this would involve a pro rata charge of indirect taxes or import charges on the exported products.

The question has been raised, however, if one should accept the rebating of indirect taxes when the rebating of direct taxes is considered an export subsidy. This provision may be rationalized on the grounds that rebating an indirect tax assures the equality of prices received by the producer for domestic and for export sales, when the domestic consumer price will equal the sum of the producer price and the indirect tax. In turn, rebating the income tax would reduce the export price below that for domestic sales.

Export Subsidies on Primary Products

As noted earlier, the General Agreement permits subsidies to exports of primary products. In this connection, the question arises what is meant by a primary product.

In the Note to Article XVI, it is stated that "a 'primary product' is understood to be any product of farm, forest, or fishery, or any mineral, in its natural form or which has undergone only such processing as is customarily required to prepare it for marketing in substantial volume in international trade." This statement clarifies the situation: for example, wheat is a primary product, but pasta is not. The reference to "marketing in substantial

volume in international trade" also means that meat (together with livestock) may be regarded as a primary product.

Article XVI:3 states that "contracting parties should seek to avoid the use of subsidies on the export of primary products." There is no obligation, however, to refrain from the use of export subsidies except that the General Agreement seeks to limit subsidization in the following case:

> "If, however, a contracting party grants directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory, such subsidy shall not be applied in a manner which results in that contracting party having more than an equitable share of world export trade in that product, account being taken of the shares of the contracting parties in such trade in the product during a previous representative period, and any special factors which may have affected or may be affecting such trade in the product (XVI:2)."

This provision has little practical value as it does not define the meaning of "equitable share" beyond reference to export market shares during a previous representative period, which is subject to diverse interpretation. The introduction of "special factors which may have affected or may be affecting such trade in the product" further adds to uncertainty.

The Code attempted to introduce greater precision in the definition in stating that "'more than equitable share of world export trade' shall include any case in which the effect of an export subsidy granted by a signatory is to displace the exports of another signatory bearing in mind the developments on world markets" and "'a previous representative period' shall normally be the three most recent calendar years in which normal market conditions existed" (10:2).

It is not clear, however, what the reference to the most recent calendar years means in cases of export subsidies for primary products that have been used for some time. Further questions arise in connection with

Article 10:3 in the Code, under which "signatories further agree not to grant export subsidies on exports of certain primary products to a particular market in a manner which results in prices materially below those of other suppliers to the same market." This provision covers only the case when there is substantial underpricing, yet export subsidization in primary products generally aims to offset differences in production costs without necessarily undercutting substantially the prices charged by low-cost producers.

Nor can refinements of these provisions suffice. Rather, one should aim at eliminating export subsidies to primary products. There is no economic rationale for the special treatment of such products; the same rules should apply to all. This is not to say that subsidies to primary products could be eliminated immediately. But, the Contracting Parties should take a commitment as to their elimination over time, and establish a timetable for the implementation of this agreement.

Domestic Subsidies

While the General Agreement prohibits export subsidies, except for primary exports and for developing countries, there is no such prohibition of domestic subsidies. At the same time, "in any case in which it is determined that serious prejudice to the interest of any contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the Contracting Parties, the possibility of limiting the subsidization" (GATT, XVI:1). This clause has rarely been used, but domestic subsidies have been countervailed.

While Article XVI of the General Agreement does not define domestic subsidies, the Code states: "Examples of possible forms of such subsidies

are: government financing of commercial enterprises, including grants, loans, or guarantees; government provision or government financed provision of utility, supply distribution and other operational or support services or facilities; government financing of research and development programmes; fiscal incentives; and government subscription to, or provision of, equity capital" (11:2)

It is further added: "Signatories note that the above form of subsidies are normally granted either regionally or by sector. The enumeration of forms of subsidies set out above is illustrative and non-exhaustive, and reflects these currently granted by a number of signatories to this Agreement" (11:2).

In fact, the list is far from exhaustive as it does not cover special credit terms provided by banks on the government's behest or preferential transport charges, for example. At the same time, questions have been raised about the specificity of a domestic subsidy.

The Group of Experts on the Calculation of the Amount of a Subsidy has submitted Draft Guidelines for the Application of the Concept of Specificity in the Calculation of the Amount of a Subsidy other than an Export Subsidy (SCM/W/89, April 25, 1985) to the Committee on Subsidies and Countervailing Measures. Under the Guidelines, only measures which are specific to an enterprise or industry or group of enterprises or industries are considered domestic subsidies from the point of view of the application of Article XVI of the Agreement.

This provision may be considered appropriate since generally applicable subsidies do not favor particular enterprises or industries, but apply across the board. For example, a government may introduce incentives to

promote investment that are available to any investor regardless of the industry.

At the same time, the Guidelines state that "it remains for the signatories to address the issue of regional specificity." In this connection, it has been argued that regional subsidies to particular enterprises or industries should be admitted as they aim at remedying the cost disabilities of particular regions.

This argument fails to consider that regional subsidies to particular enterprises or industries distort comparative advantage in the industries in question. Thus, on the regional level, too, distinction needs to be made between general and specific subsidies. General subsidies, which aim at offsetting the overall cost disabilities of a region, should not be considered domestic subsidies from the point of view of the application of Article XVI while specific subsidies should be so considered.

Article XVI:1 of the General Agreement refers to indirect as well as to direct subsidies. Indirect subsidies may be provided to inputs that are used in products which enter international trade. In this case the specificity test should apply to the final product; i.e. one should inquire if the subsidized input is specific to the final product. Thus, the existence of subsidization presumes that the input producing enterprise or industry receives a subsidy and that the input is specific to the product concerned.

A related issue is the pricing of natural resources. Governments may set a lower price for natural resources used domestically than sold internationally, thereby bestowing an advantage on domestic industry utilizing the natural resource. And, subsidies to natural resources in general may provide an advantage to industries using these resources in their export as

well as domestic sales. Finally, government ownership of natural resources may lead to discriminatory treatment.

These practices should be evaluated on the basis of the described principles on indirect subsidization. This would mean judging them on the basis of subsidization of the input concerned and its specificity to the user industry.

II. Countervailing Measures, Serious Prejudice and Nullification or Impairment

According to the General Agreement, "the term 'countervailing duty' shall be understood to mean a special duty levied for the purpose of offsetting any bounty or subsidy bestowed, directly or indirectly, upon the manufacture, production or export of merchandise" (VI:3). At the same time, the condition for levying a countervailing duty is that the subsidy "causes or threatens material injury to an established industry in the territory of a contracting party or materially retards the establishment of a domestic industry" (VI:1). It is further added that "no countervailing duty shall be levied on any product of the territory of any contracting party imported into the territory of another contracting party in excess of an amount equal to the estimated bounty or subsidy determined to have been granted, directly or indirectly, on the manufacture, production, or export of such product in the country of origin or exportation, including any special subsidy to the transportation of a particular product" (VI:3).

It is apparent that export subsidies as well as domestic subsidies can be countervailed. However, the amount of countervailing duty is limited to the subsidy bestowed on products imported into the country taking countervailing action, thus excluding subsidies that benefit exports to third

countries or domestic sales although these, too, can cause or threaten material injury to the industry of the country concerned.

Thus, countervailing action is not available in the case when a foreign subsidy adversely affects a country's sales to third markets or to the markets of the country imposing a subsidy. In these cases, Articles XVI or XXIII may apply. The former states that "In any case in which it is determined that serious prejudice to the interest of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the Contracting Parties, the possibility of limiting the subsidization" (XVI:1). The latter deals with nullification or impairment and states: "If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded ... the contracting party may, with a view to the satisfactory adjustment of the matter, make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it." (XXIII:1).

We will return to the consideration of serious prejudice and nullification or impairment following a review of various aspects of countervailing action. These aspects are the measurement of subsidy, the determination of injury, the definition of domestic industry, cumulative injury assessment, the application of the de minimis clause and 'nuisance' countervailing actions.

The Measurement of Subsidy

The General Agreement limits countervailing duties to "the estimated bounty or subsidy determined to have been granted" (VI:3). This provision has been reconfirmed and extended by the Code: "No countervailing duty shall be levied on any imported product in excess of the amount of subsidy found to exist, calculated in terms of subsidization per unit of the subsidized and exported product" (4:2). The General Agreement does not deal with the issue of measurement, however, and the Code is limited to the statement that "an understanding among signatories should be developed setting out the criteria for the calculation of the amount of subsidy" (4:2, footnote 15).

A controversy has arisen as to whether the amount of subsidy should be determined on the basis of the cost to the government or benefit to the recipient. The former position appears to be supported by the fact that, according to the provision just cited, a countervailing duty may not exceed "the estimated bounty or subsidy determined to have been granted" (VI:3). In turn, the Code's provision that "no countervailing duty shall be levied on any imported product in excess of the amount of subsidy found to exist" (4:2) has been interpreted to be consistent with the subsidy being equal to the benefit received by the producer or exporter.

From the economic point of view, the subsidy should be measured in terms of the benefit to the recipient. As a practical matter, this will usually be gauged in terms of the cost to the government. An important exception was noted above: in cases when banks provide a subsidized credit against which there are lower reserve requirements, the interest preference should be calculated relative to generally-applicable interest rates.

Under Article XVI of the General Agreement, it is the responsibility of the country granting the subsidy to indicate the extent of subsidization in notifying GATT of the existence of a subsidy. In taking countervailing action, then, the importing country may consider the estimate made in the notification to GATT as a point of departure in setting countervailing duties.

The proposed procedure would reduce uncertainty as to the measurement of the subsidy for purposes of countervailing action. It would also provide inducement to countries imposing subsidies to notify GATT on the extent of subsidization.

It is further proposed that, in the event countervailing duties are set at a level higher than the subsidy notified to the Contracting Parties, the country granting the subsidy should have the right to ask for consultation, conciliation, and dispute settlement in GATT. This would reduce existing complaints concerning countervailing action.

The Determination of Injury

The General Agreement speaks of material injury without giving a definition. In turn, the Code provides that "a determination of injury for purposes of Article VI of the General Agreement shall involve an objective examination of both (a) the volume of subsidized imports and their effect on the prices in the domestic market for like products and (b) the consequent impact of these imports on domestic producers of such products" (6:1). It is further stated:

> With regard to volume of subsidized imports the investigating authorities shall consider whether there has been a significant increase in subsidized imports, either in absolute terms or relative to production or consumption in the importing signatory. With regard to the effect of the subsidized imports on prices, the investigating authorities shall consider whether there has been a significant price undercutting by the subsidized imports as compared with the price of

> a like product of the importing signatory, or whether the effect of such imports is otherwise to depress prices to a significant degree or prevent price increases, which otherwise would have occurred, to a significant degree. No one or several of these factors can necessarily give decisive guidance" (6:2).
>
> "The examination of the impact on the domestic industry concerned shall include an evaluation of all relevant economic factors and indices having bearing on the state of the industry such as actual and potential decline in output, sales, market share, profits, productivity, return on investments, or utilization of capacity; factors affecting domestic prices; actual and potential negative effects on cash flow, inventories, employment, wages, growth, ability to raise capital or investment and, in the case of agriculture, whether there has been an increased burden on Government support programmes. This list is not exhaustive, nor can one or several of these factors necessarily give decisive guidance" (6:3).

We thus have a series of criteria and while the effect on prices is given pride of place in Article 6:1, in Article 6:3 this is only one of several criteria. At the same time, from the economic point of view, emphasis should be given to profits. Thus, one may examine the extent to which subsidies have led to reductions in profits in the affected industry below what may be considered normal profits. In so doing, adjustment would need to be made for changes in business conditions.

The question remains what is meant by material injury in the General Agreement. While this concept is not elucidated in the Code, material injury should be interpreted to mean substantial injury. Countervailing action would not be appropriate in the event that a subsidy has small and negligible effects. Thus, a substantial decline in profits attributed to the subsidy would be considered an indication of material injury.

The Definition of Domestic Industry

According to the Code, "In determining injury, the term 'domestic industry' shall, except as provided in paragraph 7 below, be interpreted as

referring to the domestic producers as a whole of the like products or to those of them whose collective output of the products constitutes a major proportion of the total domestic production of those products ... (6:5). The exception refers to the case when "the territory of a signatory may, for the production in question, be divided into two or more competitive markets and the producers within each market may be regarded as a separate industry ..." (6:7).

It is further stated that "the term 'like product' ('produit similaire') shall be interpreted to mean a product which is identical, i.e. alike in all respects to the product under consideration or in the absence of such a product, another product which although not alike in all respects, has characteristics closely resembling those of the product under consideration" (6:1, note 18). These provisions may be utilized in dealing with the controversies that have arisen in regard to the meaning of like products for raw agricultural products and for parts and components.

While it has been suggested that raw agricultural products be included with processed primary products in respect to countervailing action, this would conflict with the definition of industry in the Code. In fact, rather than being like products, raw agricultural products and processed primary products represent different levels of transformation.

Similar considerations apply to parts and components. Rather than being like products, parts and components materially differ from the assembled product. They should not be included therefore in the same industry as defined by the Code.

A further issue that has arisen in regard to the definition of domestic industry is the representativeness of the petitioners who request

countervailing action. The Code refers "to the domestic producers as a whole of the like products or to those of them whose collective output of the products constitutes a major proportion of the total domestic production of those products ..." (6:5). This may be understood to mean that requests should be acted upon if they are supported by a majority of producers, defined in terms of output value.

Cumulative Injury Assessment

The term "cumulative injury assessment" refers to the practice of defining material injury with respect to the combined effects of subsidized imports from all countries concerned. The cumulative assessment of injury increases the likelihood of affirmative findings, compared with the situation when injury is determined with respect to each exporting country, taken separately.

Neither the General Agreement nor the Code deals with cumulative injury assessment. And while references to the volume of subsidized imports in the Code (6:1) may be interpreted to refer to the cumulative assessment of injury, the opposite conclusion may be reached on the basis of a passage concerning the imposition of countervailing duty: "When the countervailing duty is imposed in respect of any product, such countervailing duty shall be levied, in the appropriate amounts, on a nondiscriminatory basis on imports of such product from all sources found to be subsidized and to be causing injury ..." (4:3).

Nevertheless, from the economic point of view, cumulative injury assessment is a sensible procedure since, for the domestic industry, it is the combined effect of foreign subsidies that matters. As long as there is

material injury that can be attributed to subsidization by foreign exporting countries, there is justification for countervailing action.

The question remains, however, if countervailing action should be taken against all subsidizing countries or only against some of them if they, combined, give rise to material injury. The answer is simple if the exporters are of equal size and provide subsidies of similar magnitude: countervailing action should be taken against all exporters in this case.

The situation is more complicated if exports vary in size and the magnitude of the subsidies differ. Now, it would be inappropriate to levy countervailing duties on the exports of countries that did not contribute to material injury. This, in turn, necessitates examining the possible effects of omitting individual countries from the calculation and taking countervailing action only against those that contributed to the material injury.

De Minimis Subsidy

Material injury could not be caused if subsidies are "de minimis," i.e. they are very small. This is because, if the subsidy is de minimis, it can be assumed that no material injury exists. The application of such a procedure conforms to Article 2:12 of the Code, according to which "an investigation will be terminated when the investigating authorities are satisfied that no subsidy exists or that the effects of the alleged subsidy on the industry is not such as to cause injury."

It has been suggested that a general definition of de minimis subsidy is not possible because of differences in factors such as the size of exports and their price sensitivity. Nevertheless, one may establish a floor in terms of subsidy rates which involves the presumption that no material injury

exists. While the choice is to a considerable extent arbitrary, it may be assumed that a subsidy rate below 1 percent does not cause material injury.

Nuisance Countervailing Actions

The application of the de minimis rule would limit "nuisance" countervailing actions that aim at discouraging exports. The question arises if other measures may also be taken to avoid such actions.

One possibility is to impose a penalty in the case when countervailing action was initiated even though no appropriate basis existed. Another would be to strengthen the preliminary review process before the claim is acted upon by the authorities of the importing country.

Serious Prejudice and Nullification or Impairment

Thus far, the discussion concerned countervailing action against subsidies that cause material injury in the importing country. As noted earlier, injury may also result when the foreign subsidy adversely affects a country's sales to third markets or to the markets of the country imposing the subsidy. In these cases, Articles XVI and XXIII may apply as noted above.

Articles XVI and XXIII are very weak provisions. Not only is there no obligation to withdraw subsidization but the GATT procedures for dispute settlement do not come into play.

Dispute settlement procedures were introduced in the Code. These would follow consultations concerning the subsidy:

> "Whenever a signatory has reason to believe that any subsidy is being granted or maintained by another signatory and that such subsidy either causes injury to its domestic industry, nullification or impairment of benefits accruing to it under the General Agreement, or serious prejudice to its interests, such signatory may request consultations with such other signatory (12:3).
>
> "If, in the case of consultations under paragraph 3 of Article 12, a mutually acceptable solution has not been reached within sixty days

> of the request for consultations, any signatory party to such consultations may refer the matter to the Committee for conciliation in accordance with the provisions of Part VI" (13:2).
>
> "If any dispute arising under this Agreement is not resolved as a result of consultations or conciliations, the Committee shall, upon request, review the matter in accordance with the dispute settlement procedures of Part VI" (13:3).
>
> "If, as a result of its review, the Committee concludes that an export subsidy is being granted in a manner inconsistent with the provisions of this Agreement or that a subsidy is being granted or maintained in such a manner as to cause injury, nullification or impairment, or serious prejudice, it shall make such recommendations to the parties as may be appropriate to resolve the issue and, in the event the recommendations are not followed, it may authorize such countermeasures as may be appropriate, taking into account the degree and nature of the adverse effects found to exist, in accordance with the relevant provisions of Part VI." (13:4).

While the provisions of Article 12 and 13 of the Code introduce conciliation and dispute settlement procedures in the event of serious prejudice and nullification or impairment, experience indicates that these procedures are not always effective. Thus, there have been cases when the Committee on Subsidies and Countervailing Measures did not act on a panel report (as in the pasta case) or one of the parties involved refused to accept the recommendations (as it occurred in a case where the United States and another where the EC was found to have violated the General Agreement). Correspondingly, it would be desirable to strengthen the rules on subsidies. This may be done by taking the EC rules as a point of departure.

The EC severely limits domestic industrial subsidies in order to avoid distorting competition in the member countries. It would be appropriate to establish rules limiting domestic subsidies in GATT as well, so as to minimize distortions in export markets and in domestic markets. This could be

accomplished by prohibiting domestic subsidies that exceed a certain percentage, say 5 percent, of output value.

It may be added that domestic subsidies can be used as disguised export subsidies. This will be the case when exports account for a large proportion of domestic production. One may, then, extend the prohibition of export subsidies in cases when exports account for, say, over 50 percent of domestic output to domestic subsidies as well.

Dispute Settlement

The proposed extension of the prohibition of export subsidies to domestic subsidies meeting certain criteria would still leave a broad range of domestic subsidies. And while specific domestic subsidies are countervailable, as noted earlier there is no possibility for countervailing action if the subsidies affect exports to third countries or to the subsidy-imposing country's own markets.

It follows that there is need to improve GATT mechanisms to deal with cases of serious prejudice and nullification or impairment. This would necessitate improving the existing GATT dispute settlement procedure. Such improvements are also necessary if we consider that other contentious issues may arise in the application of Articles VI and XVI.

Particular importance attaches to timeliness in decision making and in implementation. A ruling by a panel should be made by a specified date and the party found to have violated the General Agreement should have a specific time to object to the ruling. Once the ruling becomes final, it should be carried out within a short period and it should not be subject to blocking by the party who has been found to have violated the Agreement.

The developed countries have a particular responsibility to abide by panel rulings. In this regard,there are some hopeful signs, e.g. Japan accepted the ruling on abolishing restrictions on the imports of 12 foodstuffs. There has also been an increase in the number of trade disputes brought to GATT and dispute settlement panels have speeded up their work.

III. Special Treatment of Developing Countries

GATT Rules on Subsidies by Developing Countries

Developing countries did not subscribe to Article XVI:4 of the General Agreement that prohibits the use of export subsidies on products other than primary products. Article 14 of the Code further notes: "Signatories recognize that subsidies are an integral part of economic development programmes of developing countries" (14:1). "Accordingly, this Agreement shall not prevent developing country signatories from adopting measures and policies to assist their industries, including those in the export sector" (14:2).

At the same time, "developing country signatories agree that export subsidies on their industrial products shall not be used in a manner which causes serious prejudice to the trade or production of another signatory" (14:3). However, "there shall be no presumption that export subsidies granted by developing country signatories result in adverse effects, as defined in this Agreement, to the trade and production of another signatory. Such adverse effects shall be demonstrated by positive evidence, through an economic examination of the impact on trade or production of another signatory" (14:4).

These provisions conform to GATT rules establishing special and differential treatment for developing countries. Thus, Article XVIII added in

1955 recognizes that it may be necessary for developing countries "to take protective or other measures affecting imports" (XVIII:2) and "to grant the governmental assistance required to promote the establishment of particular industries" (XVIII:3). Furthermore, Article XXXVI, added in 1965, takes note of the need "for a rapid and sustained expansion of the export earnings of the less-developed contracting parties" (XXXVI:2), and "for positive efforts designed to ensure that less-developed contracting parties secure a share in the growth in international trade commensurate with the needs of their economic development" (XXXVI:3). Also, it is stated that "the developed contracting parties shall ... have special regard to the trade interests of less-developed contracting parties when considering the application of other measures permitted under this Agreement to meet particular problems and to explore all possibilities of constructive remedies before applying such measures where they would affect essential interests of those contracting parites" (XXXVII:3).

As noted in a note of the GATT Secretariat ("Incentives to Industrial Exports from Developing Countres, COM/TD/72, March 17, 1970 Para. 7) "it is clear from the drafting history of Part IV [of the General Agreement] that countervailing duties are among the measures permitted to meet particular problems" referred to in Article XXXVII:3. It does not appear, however, that the developed countries would have given preferential treatment to developing countries in the application of countervailing duties.

Optimal Policies for Developing Countries

On economic grounds, deviations from free trade can be justified on the grounds of externalities in production. In developing countries, externalities may involve the creation of new skills as well as technological

improvements, the benefits of which are not fully captured by the firm. Such externalities exist in the manufacturing sector of the developing countries, although their magnitude should not be overstated. Thus, they warrant preferential treatment of this sector to a limited extent only.

Ideally, preferential treatment to manufacturing activities should be provided by production subsidies that provide the same incentive to sales in domestic and in foreign markets and do not distort the pattern of consumption. By contrast, tariffs discriminate against exports and in favor of import substitution and distort the pattern of consumption by raising the prices of manufactured goods.

Production subsidies are not practicable in most developing countries because of their limited capacity to pay taxes which would finance the subsidies. Rather, developing countries rely largely on import tariffs that constitute government revenue.

The application of import tariffs and export subsidies at equal rates has advantages over reliance on import tariffs alone. Under this alternative, the same increase in domestic production can be attained at lower tariffs and there is no discrimination against exports. And although consumption is distorted, the revenue needs of export subsidies are less than those of production subsidies.

Steps toward the equalization of incentives to import substitution and exports may be taken by a devaluation accompanied by reductions in import duties. The devaluation would provide incentives to exports while import protection would be reduced to the extent that reductions in tariffs exceeded the rate of devaluation. For example, a 10 percent devaluation accompanied by a 20 percent reduction in tariffs would lower import protection by 10 percent

and increase incentives to exports by 10 percent. This is because a 10 percent devaluation is equivalent to a 10 percent import tariff cum export subsidy.

The described procedure would reduce but not eliminate the bias of the incentive system against exports. In order to further reduce this bias, developing countries should make use of the rules provided by GATT to rebate import duties on imported inputs and indirect taxes on all inputs used in export production, extending these rebates to indirect inputs.

Rebating duties and indirect taxes, used to good effect by the East Asian NICs, would put the export sector on a free trade footing. Extending the rebates to indirect inputs is especially important, both to reduce the cost of exports and to ensure the backward integration of the production process through the domestic production of inputs for exports.

Developing countries may also provide preferential credit to exports to the extent allowed by the OECD agreement on official export credits, referred to in the illustrative list of export subsidies and give preference to exporters in the event credit is rationed. Export insurance schemes can further be set up in the absence of the private provision of such insurance. And, exports can be assisted through investment in infrastructure, from the building of ports complemented by access roads and railway connections to the establishment of a modern telephone system.

Governmental and paragovernmental organizations may further use measures of export promotion. Such promotional measures include the organization of trade fairs and trade missions, the collection of information on market possibilities for export, the establishment of trade centers and of consular services to promote exports, as well as quality control.

Beyond these measures, export subsidies may be provided in cases when countervailing action does not threaten. This will be the case for exporters that do not cause injury to developed country industries, including small countries as well as the exports of large countries that account for a small proportion of developed country markets.

The Graduation Clause

As developing countries industrialize, the importance of production externalities, and hence the need for the preferential treatment of the manufacturing sector, will decline. Correspondingly, these countries may reduce reliance on import tariffs and export subsidies. Eventually, developing countries may forego the use of export subsidies and accept GATT rules on the prohibition of these subsidies.

The described situation is foreshadowed in the Code, according to which "a developing country signatory should endeavor to enter into a commitment to reduce or eliminate export subsidies when the use of such export subsidies is inconsistent with its competitive and development needs" (14:5). The Code does not provide, however, for a procedure that would ensure graduation as developing countries industrialize.

Yet, it would be desirable to establish a procedure to deal with the case of advanced developing countries as well as with the case when an industry of a developing country is internationally competitive. This procedure may take the form of the application of the dispute settlement procedure in GATT, involving rulings by a panel on complaints submitted to GATT.

IV. Conclusions

This paper has examined issues relating to subsidies and countervailing measures and made recommendations for changes in existing rules on the basis of economic considerations. This has been done in regard to subsidies; countervailing measures and serious prejudice, nullification or impairment; and the special treatment of developing countries.

It is suggested that the illustrative list of export subsidies be made definitive, following appropriate revisions. These revisions would eliminate the dual pricing of inputs and remove the requirement of the physical incorporation of inputs for the exemption and remission of indirect taxes and import charges. At the same time, the exception made for primary products in regard to the prohibition of export subsidies should be eliminated over time.

Only measures which are specific to an enterprise or industry or group of enterprises or industries should be considered domestic subsidies from the point of view of the application of Article XVI of the Agreement. This rule should also be applied to regional subsidies and to subsidies provided to inputs.

Both export subsidies and domestic subsidies are countervailable if they cause or threaten material injury to an established industry or materially retard the establishment of a domestic industry of an importing country. In this connection, several issues arise.

First, the subsidy should be measured in terms of the benefit to the recipient and reported to GATT as part of the procedure of notifying the existence of a subsidy, with the estimate used as a point of departure in setting countervailing duties. Second, material injury should be interpreted

to mean substantial injury and gauged in terms of changes in profits attendant on the imposition of the subsidy. Third, domestic industry should be defined to exclude raw agricultural materials for processed products and parts and components for final products. Fourth, cumulative injury assessment should be applied, with countervailing action foregone in regard to the exports of countries that did not contribute to the material injury. Fifth, material injury should be assumed not to exist if the subsidy is de minimis. Sixth, procedures should be adopted that reduce the chances of initiating nuisance countervailing action.

Countervailing action is not available in cases when a foreign subsidy adversely affects a country's sales to third markets or to the markets of the country imposing the subsidy. In cases when the subsidy causes serious prejudice or nullification or impairment of benefits that would otherwise accrue to a country under the General Agreement, there are only weak provisions for possible rectification.

Correspondingly, it would be desirable to strengthen existing rules on subsidies. This could be accomplished by prohibiting domestic subsidies that exceed a certain percentage of output value as well as domestic subsidies provided in cases where exports account for a large proportion of output. It would also be necessary to improve the existing GATT dispute settlement mechanism.

Developing countries receive preferential treatment in the application of GATT rules on subsidies. They are exhorted, however, to reduce or eliminate export subsidies which are inconsistent with their competitive or development needs. It is suggested that the procedures be established to deal with the case of advanced developing countries and with the case when an industry of a developing country is internationally competitive.

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